Russian Corporate Governance Roundtable

WORKSHOP: IMPLEMENTATION AND ENFORCEMENT OF DISCLOSURE RULES

Moscow, 2-3 October 2003

COMING TO GRIPS WITH RELATED PARTY TRANSACTIONS[*]

PROFESSOR DR. UWE H. SCHNEIDER
Direktor des Instituts für deutsches und internationales
Recht des Spar-, Giro- und Kreditwesens
an der Johannes Gutenberg-Universität Mainz

I.

1. The excellent presentation, which we just heard, gave a perfect overview over the rules concerning related party transactions. With my comments I could only water down this analysis. Instead I will try to open a new dimension namely: Good corporate governance in groups of corporations. That is a topic, which was not mentioned by Mats Isaksson, when he listed the issues, which are discussed in the Steering Group and which may be reflected in the new "Principles".

2. Today not only multinational businesses but also small and medium size businesses are not organized by just one corporation but by a group of corporations. DaimlerChrysler and General Electric, Nestle and Exxon, consist of a holding company and hundreds or thousand's of subsidiaries. And that is probably also true for Gazprom and Jukos. And even smaller corporations, which are listed at the Stock Exchange have ten, twenty or thirty subsidiaries. It is one of the lacunae in modern company law that the problems of these groups are not reflected in our statutes – with a few exceptions, namely accounting law and tax law. Also in the OECD-Principles of Corporate Governance groups of corporations are rarely mentioned.

3. All matters, which are regulated in our corporation law and codes of good corporate governance have to be reanalyzed for groups. Try to answer the following questions: What are the rules for setting up a group? What are the rules for the decision making process in the group? Are directors of a holding company responsible for illegal acts such as bribery or for wrongful trading in subsidiaries. To what extent is the supervisory board of the holding company obliged to supervise the business in subsidiaries? What are the rules for financing the group, for the distribution of profits and intra-group loans? Has the shareholder of the holding a right to be informed about the business in subsidiaries? To what extent can he participate in decisions, which are made in subsidiaries? Again, if you read our statutes or our modern codes of best practice you will find no answers to all these questions. Neither the EU nor the US or Canada have a codified law of groups of cor

4. porations. I propose, we make this the topic for our next Russian Corporate Governance Roundtable.

[*] The views expressed in this paper are those of the author and do not necessarily represent the opinions of the OECD or its member countries.

5. To be more clear and concrete, I want to demonstrate the issues in the light of one problem, namely related party transactions and groups of corporations:

- First: It is obvious, that a director may not take the money of the corporation and put it into his own pocket. And he is not allowed to pay his own bills with the money of the corporation. That behaviour is a crime.

- Second: But practice is more sophisticated and the law should follow the practice! Directors, Members of the supervisory board, officers and employees should not take advantage of their position in the company. That is the policy behind our rules on third party transactions. To avoid a conflict of interests, directors are restrained from trading in the same business. They have a no-competition clause. If the corporation produces trucks the director is not allowed to produce trucks on his own account. That means also, that the director is not allowed to participate as a major shareholder in a corporation, which produces trucks. And on the other side the director of a holding company with a subsidiary, which produces trucks is also in the range of the no-competition clause. Therefore no-competition clauses have to be interpreted group-wide.

- Third: There is a similar situation with contracts between directors and their corporation. Who controls whether the price of those contracts is fair; and in case of loan contracts, who controls whether the director is credit-worthy? Will he be able to pay the loan back? Some countries forbid loan contracts between the director and his corporation. In contrast, German law allows those contracts but German law provides that loan contracts between the corporation and the director are only valid if the supervisory board has agreed. In order to avoid informing and getting the necessary consent of the supervisory board, directors try to get loans from the subsidiary. And sometimes they sent the wife or the children or set up a company, which becomes the debtor. It seems obvious that the same rules must apply.

6. And that is my first conclusion. Part of good corporate governance are no-competition clauses and rules for party transactions. I do not agree that disclosure, as foreseen in the OECD-Principles is sufficient. At least loan contracts should be controlled. It is the supervisory board, which is best suited for this task. And the rules concerning related party transactions should provide that they may not be undermined in groups of corporations.

II.

7. Now I turn to a more complicated area of party related transactions namely intragroup transactions. Take an example: In a pyramid of corporations a subsidiary rents office space from the holding company. The rent is above market price. Those unfair intragroup contracts are to the detriment of the minority shareholders and the creditors of the subsidiary. It is a form of hidden distribution of profits.

8. There are many questions which arrise. I only name four:

- First: Are the shareholders of the various companies of the group informed about the group-structure? Probably not. The OECD-Principles only provide that investors should be informed about the ownership structure of the enterprise. That ist not sufficient. The investors should also be informed about the whole group-structure, about the subsidiaries and the shareholdings in the subsidiaries.
- Second: Do directors of subsidiaries violate their duties if they conclude a contract with the holding company, if the price is not fair. Under German law they do not breach their duties. On the first sight that seems strange. But this solution has to be seen in the context that the holding corporation has to compensate the subsidiary within one year. And directors of the holding company do not only violate their duties which they owe the holding company but also the duties which they owe the subsidiaries, if they take profit from business opportunities of the subsidiaries.
- Third: The main problem is enforcement. Who controls that compensation is payed? Neither the minority shareholder of the subsidiary nor the shareholder of the holding company has the right to be informed about intragroup transactions. They remain in the fogTherefore the subsidiary should obliged to report every year all intragroup transactions and whether compensation has been payed. And the shareholders should be informed about this report. Only full disclosure meets the expectations and the necessary protection of the investors.

- Fourth: And what happens if the holding company has caused transactions, which cannot be compensated and therefore the subsidiary goes bankrupt. The German Supreme Court recently decided that under that circumstances the holding company is liable for all debts of the subsidiaries.

9. And that is my second conclusion: Also intragroup – transactions should be fair – or they should be compensated. It is good corporate governance, if the fair price of intragroup transactions can be controlled and that the necessary compensations are made transparent.